

## Value of the Rate Study in Project Finance

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### Introduction

Undertaking the task of completing a water or wastewater system project can be a difficult and time consuming process. Some districts may not have the resources available, in terms of labor, experience, and monetary reserves, to accomplish the task in a timely and efficient manner. General managers and other staff are often busy with the day to day needs of managing and operating the district and need assistance with the details of getting the project funded through the loan closing process.

Successfully funding these projects usually requires some level of debt financing as most districts do not have the large cash reserves necessary to pay for the project in its entirety. Sources of funds include various federal and state agencies and traditional debt markets. These lenders typically request certain information from the applicant that may include information regarding the project, the utility system, and the community. Federal and state agencies often use this information to determine any grant eligibility and general loan terms.

Debt financing the project in whole or in part introduces a number of issues and questions for the district. Some of these may include the following.

- Are revenues sufficient, now and in the future, to pay for the additional debt payments?
- What are the debt service coverage requirements that the district must meet?
- How do the rates have to change now and over time to ensure that the district meets its annual obligations and charge customers fairly?
- Will the rates be affordable for the community?
- What is the process required to implement new water or wastewater rates?

### Utility Rate Study

These issues and questions can best be addressed through conducting the utility rate study. The rate study generally consists of three parts that include (1) financial planning, (2) determination of the cost of providing service to customers, and (3) designing utility rate structures and rates.

### Financial Plan

A traditional utility rate study develops rates and charges that are designed to meet the revenue targets of a forward looking financial plan. The financial plan consists of projected revenues and financial obligations (revenue requirements) of the utility enterprise fund for a future period of at least five years. The financial plan brings together all of the revenues and revenue requirements of the enterprise and shows whether financial obligations are being met in each year of the study period, or if revenue increases will be needed. The financial plan demonstrates the ability to repay debt (now and in the future) and the degree to which debt is “covered” by net revenue. The financial plan will also incorporate good management practices such as provision for system replacement, and maintenance of operating and capital reserves.

### Cost Allocation

The objective of the cost allocation is to distribute the utility’s costs fairly among the customers that use the facilities. Annual costs for a representative year from the financial plan are allocated to customer classifications. The allocation method that is used depends on several factors. A few of these may include the level of detail of the utility’s accounting system, system operations, whether consumption is entirely metered, and the type of treatment facility process that is used to provide service.

### Rate Structure and Rates

Rate structures and rates are designed to recover the costs of service allocated to the utility’s customer classifications. Various types of structures can be employed to recover the costs. For a water utility, these commonly include a fixed charge and consumption charge. The fixed charge may recover a portion of fixed costs as well as some demand related costs of the system. The consumption charge can consist of a uniform rate, or consist of rates by consumption block such as an inclining block



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rate structure when developing water conservation rates. For a wastewater utility, rate structures may include fixed charges, volume charges, wastewater strength charges, or combinations of any of these types. The intent is to design rate structures and rates that stand alone as a separate revenue source that fairly recovers the cost of providing service to the utility's customer groups.

**Rate Implementation and Proposition 218 Requirements**

The design of water and wastewater rates in California must comply with Proposition 218. Under this legislation, the revenue derived from the rates cannot exceed the cost to provide the service and the revenue cannot be used for any other purpose for which the rates were imposed. Additionally, the rates charged must not exceed the proportional cost attributable to a parcel and should be proportional to actual use.

Implementing new rates includes several tasks defined in the Proposition 218 legislation. Written notices are required to be mailed to each affected parcel and owner of record. The notices should include the amount of the fee or charge that will be imposed on each parcel, the basis upon which the amount of the fee or charge was calculated, the reason for the fee or charge, and the date, time, and location of a public hearing regarding the new rates. The basis for the fee or charge calculations is provided by the rate study report.

Proposition 218 also requires the district to conduct a public hearing on the proposed rates. The public hearing should

not be conducted less than 45 days after the district has mailed the notices. At the public hearing, the district should consider all protests against the rates, and if there is not a majority of owners of the parcels that protest against the rates, then the district may implement the rates.

**Conclusion**

The value of the rate study is optimized when it is conducted at the time a district is pursuing grants and loans for a project(s). The rate study's pro forma cash flow can be submitted with various pre-applications for funding, showing the enterprise fund's capacity for additional parity lien or junior lien debt and how loans will be repaid. The financial plan is particularly useful to lenders as it presents the financial stability of the enterprise. Most lenders require that the utility have rates approved through the Proposition 218 process prior to loan closing and the rate study is essential to completing this task. The rate study's financial plan can also be updated during the performance of the study as engineering cost estimates of the project change, ultimately presenting a clear picture to the public of the utility's intent at the time of the public hearing.

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The CSDA Finance Corporation has been making tax-exempt financing accessible to special districts since 1988. Since then, the Finance Corporation's team of consultants has facilitated the funding of nearly \$1 billion million for capital improvement projects, equipment purchases, and refinancing of prior debt.

If your district is burdened with a CalPERS side fund and would like to learn how the CSDA Finance Corporation can help, please contact Program Manager Cathrine Lemaire at 877.924.2732 or [cathrine@csda.net](mailto:cathrine@csda.net).